BEFORE THE

PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

In Re:	)	
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Affordable Phone Services, Incorporated d/b/a High Tech Communications	)	Docket No. 2010-14-C
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Dialtone & More Incorporated	)	Docket No. 2010-15-C
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Tennessee Telephone Service, LLC d/b/a Freedom Communications USA, LLC	)	Docket No. 2010-16-C
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. OneTone Telecom, Incorporated	)	Docket No. 2010-17-C
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. dPi Teleconnect, LLC	)	Docket No. 2010-18-C
BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Image Access, Inc. d/b/a New Phone	)	Docket No. 2010-19-C

DIRECT TESTIMONY OF
CHRISTOPHER C. KLEIN, PH.D.
ON BEHALF OF
AFFORDABLE PHONE SERVICES, INCORPORATED D/B/A HIGH TECH COMMUNICATIONS
DIALTONE & MORE INCORPORATED
TENNESSEE TELEPHONE SERVICE, LLC D/B/A FREEDOM COMMUNICATIONS USA, LLC
ONETONE TELECOM, INCORPORATED
DPI TELECONNECT, LLC
AND
IMAGE ACCESS, INC. D/B/A NEW PHONE

Q. Please state your name and your current position.

A. My name is Christopher C. Klein and I am an Associate Professor in the Economics and Finance Department at Middle Tennessee State University (MTSU) in Murfreesboro, Tennessee.

Q. Are you the same Christopher C. Klein who filed direct testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. I will respond to the pre-filed direct testimony of Dr. William E. Taylor on behalf of AT&T.

Q. How do you differ with Dr. Taylor on the resale treatment of the Cash Back, Line Connection Charge Waiver (LCCW) and Word-of-Mouth referral offerings by AT&T?

A. The difference of primary importance is the method for calculating the avoided cost of these promotional offerings in order to arrive at the wholesale rate. I also recommend resale of the Word-of-Mouth referral offering and Dr. Taylor does not.

Q. How does your calculation of avoided cost differ from Dr. Taylor's?

A. I apply the avoided cost discount percentage to the standard or "tariffed" retail rate in order to get the avoided cost associated with these promotional offerings. Dr. Taylor, in contrast, applies the avoided cost discount percentage to the promotional rate, the standard retail rate less the value of the promotion, in order to derive the avoided cost for these promotional offerings. As a result, the avoided cost of each service under each promotional offering is less for Dr. Taylor than it is under my calculation.

Q. Can you illustrate the difference in calculating the avoided cost with an example?

A. Yes. Suppose a service regularly retails for $75.00 per month and that the avoided cost discount is 20%, then Dr. Taylor and I both calculate the monthly wholesale rate for this service in the absence of a promotion as

Monthly Wholesale Rate = $75.00 – (0.20)($75.00) = $75 - $15 = $60 .

Now suppose that AT&T offers a $50.00 "cash back" promotion for new customers who sign up for this service. Both Dr. Taylor and I acknowledge that the FCC's rules require that the "cash back" offer be made available for resale. Under my method of calculating the wholesale rate, the cash back promotion does not affect the avoided cost of the service: The reseller who resells the cash back offer pays the $60.00 monthly wholesale rate for the service each month and applies for the cash back offer for qualifying customers. In the month that the $50 cash back credit is given to the reseller, the reseller receives a billing credit of $50.00, resulting in a net payment to AT&T of $10 in that month.

Contrast this with Dr. Taylor's method for the cash back promotion. The reseller still pays the $60 monthly wholesale rate for the service, based on the $15 avoided cost as calculated above, each month and applies for the cash back offer for qualifying customers. In the month that the promotional credit is given to the reseller, however, the avoided cost suddenly changes for Dr. Taylor. *For this month and for this customer only*, Dr. Taylor's wholesale rate becomes

Dr. Taylor's Cash Back Month Wholesale Rate =

$75 – (0.20)($75 - $50) = $75 – [(0.20)($75) - (0.20)($50)]

= $75 - $15 + $10 = $70 .

Dr. Taylor applies the avoided cost discount twice: once to the standard retail rate and again to the cash back. As a result, the wholesale rate *rises* to $70, but *only in the month that the promotional credit is realized*.

In the month that the promotional credit is received by the reseller, the reseller receives a billing credit for the $50 cash back. This results in a net payment by the reseller to AT&T of $70 - $50 = $20. Thus, Dr. Taylor has the reseller pay *more* for the service when the value of the promotion is realized. This is backwards.

Q. Can you compare these methods with what a retail customer pays over several months?

A. Yes. Suppose the $50 cash back is paid in the third month after a qualifying customer signs up for the service. Then payments for a retail customer and a reseller under both methods for the first four months are given in the following table. The effect of Dr. Taylor's method is to reduce the avoided cost in one month for no apparent reason.

TABLE 1

	Month 1	Month 2	Month 3	Month 4
Retail Customer				
Retail rate	$75	$75	$75	$75
Cash Back			$50	
Net Payment	$75	$75	$25	$75
Dr. Klein's Resale				
Retail rate	$75	$75	$75	$75
Avoided Cost	$15	$15	$15	$15
Cash Back			$50	
Net Payment	$60	$60	$10	$60
Dr. Taylor's Resale				
Retail rate	$75	$75	$75	$75
Avoided Cost	$15	$15	$5	$15
Cash Back			$50	
Net Payment	$60	$60	$20	$60

Q. Does it make sense for the avoided cost of a service to suddenly decline in one month for one customer just because AT&T happens to pay that customer a cash back amount in that month?

A. No. It makes no economic sense whatsoever. The actual avoided cost of a service may change from time to time, but over long periods may be expected to approximate the avoided cost discount as a percentage of the relevant revenues. The original calculation of the avoided cost discount in most states recognized this. There is no reason to expect the avoided cost of a service to change for a customer in the month that customer receives a cash back payment, while the avoided cost of the service for all other customers, and for that customer in all other months, stays the same.

Q. Is it important to maintain the same avoided cost discount as a percentage rather than a dollar amount when developing the wholesale rate for resale of promotional offerings?

A. The issue of the percentage avoided cost discount versus the dollar amount of the discount as raised by Dr. Taylor is a complete red herring. It asks the wrong question. The relevant question is: to which rate is the avoided cost discount percentage applied in to calculate the wholesale rate for resale of promotional offerings? The answer will depend on the nature of the promotion, because a one-time cash rebate is different from a temporary promotional change in the standard retail rate.

Q. What do you mean by the nature of the promotion?

A. The simplest form of a promotion is a temporary discounting from the standard retail rate, such as a 10% reduction in the retail rate available to customers who sign up for the service while the promotion is in effect. By contrast, the Cash Back promotion is a one-time rebate that a customer receives if he or she qualifies for and seeks the rebate. There is no change to the standard retail or “tariffed” rate charged to the customer. Even AT&T’s website refers to the Cash Back reward as a rebate (Stipulations, Exhibit E.)

Q. What forms do the LCCW and Word-of-Mouth referral promotions take?

A. The LCCW, at first glance, *appears* to be temporary promotional discounting of the standard retail rate, but turns out to function as a rebate from the point of view of a reseller. The Word-of-Mouth referral promotion is a classic example of a rebate.

Q. How does the LCCW function as a rebate?

A. The LCCW waives the line connection charge for select customers. Those customers are not charged for and do not pay the connection charge. The Stipulations describe resale of the LCCW as requiring the reseller to pay the standard wholesale rate up front, then to apply for the waiver. If the reseller's customer qualifies for the LCCW, then the reseller receives a credit. From the reseller's perspective, the LCCW also functions as a rebate. Dr. Taylor makes the same point in likening the LCCW to a cash back offer.

Q. What difference does it make whether the promotion offers a temporary discount to the standard retail rate or a one-time rebate?

A. A temporary promotional discount of the monthly standard retail rate is the most obvious type of promotion that the FCC sought to require the ILECs to provide to resellers in 47 CFR § 51.613(a)(2). A discounting of the monthly rate is realized immediately by the customer on the first bill and continues monthly for the life of the promotion. A rebate, in contrast, requires the customer to sign up for the service at the standard monthly retail rate, then apply for and receive a one-time payment or credit at a later date.

Rebates have been a subject of study in the marketing literature for many years.[1] In addition to requiring the customer to apply for the rebate after purchasing the good or

[1] Some examples include Lu, Qiang and Sridhar Moorthy. 2007. "Coupons vs. Rebates." *Marketing Science*, 26(1):67-82; Tat, Peter, William A. Cunningham, III, and Emin Babakus. 1988. "Consumer Perceptions of Rebates." *Journal of Advertising Research*, August-September, 45-50; Jolson, Marvin A., Joshua L. Wiener, and Richard B. Rosecky. 1987. "Correlates of Rebate Proneness." *Journal of Advertising Research*, Fenruary-March, 33-43.

service at the standard retail rate and the delay in receiving the rebate amount, rebates are also characterized by “slippage”- the tendency for only a fraction of the eligible consumers to actually apply for the rebate. With slippage, a company offering a rebate can increase its sales by attracting new customers, but only have to pay a fraction of the promised rebate amounts as some eligible customers fail to pursue the rebate.

Q. Do the FCC’s rules require rebates to be available for resale?

A. Yes. The FCC’s rules at 47 CFR § 51.603 require:

> (a) A LEC shall make its telecommunications services available for resale to requesting telecommunications carriers on terms and conditions that are reasonable and non-discriminatory..
>
> (b) A LEC must provide services to requesting telecommunications carriers for resale that are equal in quality, subject to the same conditions, and provided within the same provisioning time intervals that the LEC provides these services to others, including end users.

A rebate is a term or condition of service that must be offered to a reseller in the same manner as offered to a retail customer and is protected by the prohibition on restrictions on resale in 47 CFR § 51.613(b).

Q. What is the appropriate wholesale rate for a rebate offering?

A. A rebate does not change the standard or “tariffed” retail rate paid by the consumer, so the wholesale rate for the service is not changed. That is, the wholesale rate remains the standard retail rate less the avoided cost discount as shown in Table 1 under “Dr. Klein’s Resale.” The rebate is credited to the reseller when it applies for the rebate for a qualifying customer in the same way the rebate is credited to a qualifying AT&T retail customer. Thus, the FCC's rules that require a service to be offered under the same terms and conditions at wholesale as at retail are satisfied.

Q. Does this methodology apply to both the Cash Back offer and the Word-of-Mouth referral offering?

A. Yes. The Cash Back offer and the Word-of-Mouth referral offer are structured as rebates. There is no change to the standard or "tariffed" retail rate.

Q. How should the wholesale rate for the LCCW be calculated?

A. For the reseller, the LCCW is also in the form of a rebate. The wholesale rate for the LCCW should be calculated by applying the avoided cost discount to the standard retail rate, and giving the reseller the same rebate that the retail customer receives.

Q. Does Dr. Taylor propose this method for calculating the wholesale rate under the LCCW?

A. No. Dr. Taylor applies the avoided cost discount to the effective promotional rate of zero to get an avoided cost of zero and also a wholesale rate of zero. This creates an effective wholesale rate that is equal to the effective retail rate and thus evades AT&T's resale obligation.

Q. Can you provide an example that shows the results of these different methods?

A. Yes. Suppose the standard retail line connection charge is $50 and that the avoided cost discount is 20%. The effects of the different methods for calculating the wholesale rate under the LCCW are provided in Table 2 below.

Table 2

	Retail Customer	Klein Resale	Taylor Resale
LCC Retail rate	$50	$50	$0
Avoided cost		$10	$0
Wholesale rate		$40	$0
Credit or rebate	$50	$50	$0
Net payment (credit)	$0	($10)	$0

Q. Why is the retail rate shown as zero for Dr. Taylor's resale in Table 2?

A. Dr. Taylor calculates the avoided cost under the LCCW as the avoided cost discount applied to the effective promotional rate of zero. This is equivalent to assuming that the retail rate is zero.

Q. What would be the result of treating the LCCW as a cash back offer on a service with an up-front charge followed by a monthly rate?

A. This results in an outcome similar to that in Table 1.

Q. Can you construct an example to illustrate this outcome?

A. Yes. Suppose the standard monthly retail rate for a service is $75, the standard retail rate for the LCC is $50, and that the avoided cost discount is 20%. Table 3 shows the first four month's net payments at retail and under both resale methods assuming the reseller receives the LCCW rebate in month 3.

TABLE 3

	Month 1	Month 2	Month 3	Month 4
		Retail Customer		
Retail rate	$75	$75	$75	$75
LCC rate	$50			
Rebate or credit	$50			
Net Payment	$75	$75	$75	$75
		Dr. Klein's Resale		
Retail rate	$75	$75	$75	$75
LCC rate	$50			
Avoided Cost	$25	$15	$15	$15
Rebate or credit			$50	
Net Payment	$100	$60	$10	$60
		Dr. Taylor's Resale		
Retail rate	$75	$75	$75	$75
LCC rate	$0			
Avoided Cost	$15	$15	$5	$15
Rebate or credit	$0			
Net Payment	$60	$60	$60	$60

Q. Can you explain the difference between the results of your method and those of Dr. Taylor's method?

A. Yes. Under my method, the reseller pays the full wholesale rates for the service and the LCC in the first month, $125 - $25 = $100, then receives a $50 rebate for the LCC in month three. Dr. Taylor uses the effective promotional rate of zero for the LCC in month one, resulting in no avoided cost for the LCC and a wholesale rate of zero, and a payment to AT&T of just the wholesale monthly rate for the service. The net difference between my method and Dr. Taylor's is that the reseller pays $10 less under my method over the three month period. This is just the avoided cost associated with the LCC, demonstrating that AT&T's resale obligation is maintained by my method.

Q. What is the effect of Dr. Taylor's method?

A. Dr. Taylor's method yields the nonsensical result that the avoided cost fall whenever the LCCW is in effect and then rise when it is not in effect. There is no reason to expect the avoided cost of the LCC to fall just because AT&T is running a promotion and then to rise when the promotion is removed. Calculating the avoided cost by applying the avoided cost discount to the standard retail rate will yield the same avoided cost as long as the standard retail rate is not changed. This is consistent with the original calculation of the avoided cost discount.

Q. Is there an issue concerning the avoided cost percentage versus the avoided cost dollar amount?

A. No. The avoided cost discount percentage is unchanged and should be applied to the standard retail rate as shown in Table 2 to arrive at the wholesale rate under the LCCW.

Q. Does Dr. Taylor disagree with your treatment of the Word-of-Mouth referral offering?

A. Yes. Dr. Taylor recommends against resale, while I recommend resale.

Q. How do you see the Word-of-Mouth referral?

A. The Word-of-Mouth referral is just a rebate for which a customer must qualify by referring another customer to AT&T. FCC rules require rebates to be available for resale. As I demonstrate in Table 1, a rebate should be credited in full to a reseller with a qualifying customer. This treatment of the Word-of-Mouth referral offering is identical to that of the Cash Back offering. Dr. Taylor's objections to the resale of this offering are just attempts to obscure the simplicity of the rebate or to complicate the analysis by referring to the rebate as a marketing expense. AT&T's classification of the rebate for its own internal purposes is irrelevant. The Word-of-Mouth referral rebate is offered to AT&T customers as a term or condition of service and should be made available for resale. Otherwise, AT&T is evading its resale obligation.

Q. Is the treatment of resale of rebate offerings that you propose fair to AT&T?

A. Yes. AT&T receives the same revenue net of avoided cost under the rebate promotion regardless of whether AT&T sells a service to a customer or a reseller sells the service. When AT&T sells the service under a rebate promotion, it receives the standard retail rate and incurs the avoided cost, then pays the rebate later when the customer qualifies for it. When a reseller sells the service under a rebate promotion, AT&T receives the standard wholesale rate (the standard retail rate less avoided cost), does not incur the avoided cost, and pays the rebate to the reseller later when the reseller qualifies for it. The results are the same. AT&T should be indifferent between selling a service with a rebate promotion itself and providing it through resale to a reseller.

Q. Does this conclude your testimony at this time?

A. Yes.

BEFORE

THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NOS. 2010-14--19-C

IN RE: BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Affordable Phone Services, Incorporated d/b/a High Tech Communications **Docket No. 2010-14-C** BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Dialtone & More Incorporated **Docket No. 2010-15-C** BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Tennessee Telephone Service, LLC d/b/a Freedom Communications USA, LLC **Docket No. 2010-16-C** BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. OneTone Telecom, Incorporated **Docket No. 2010-17-C** BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. dPi Teleconnect, LLC **Docket No. 2010-18-C** BellSouth Telecommunications, Incorporated d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Image Access, Incorporated d/b/a New Phone **Docket No. 2010-19-C**	))	**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that a copy of the **Direct Rebuttal Testimony of Christopher C. Klein, PH.D.** has been served by electronic mail service on the following this 1st day of October, 2010:

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